

Management of Operational Risk in Foreign Exchange

The Foreign Exchange Committee

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Management of Operational Risk in Foreign Exchange

Introduction

The FX Marketplace

The foreign exchange (FX) market is the largest and most liquid sector of the global economy. According to the 2004 Triennial Survey conducted by the Bank for International Settlements, FX turnover averages \$1.9 trillion per day in the cash exchange market and an additional \$1.2 trillion per day in the over-the-counter (OTC) FX and interest rate derivatives market.¹ The FX market serves as the primary mechanism for making payments across borders, transferring funds, and determining exchange rates between different national currencies.

The Changing Marketplace

Over the last decade, the FX market has become more diverse as well as much larger. Although in the past, commercial banks dominated the market, today participants also include commercial as well as investment banks, FX dealers and brokerage companies, multinational corporations, money managers, commodity trading advisors, insurance companies, governments, central banks, pension and hedge funds, investment companies, brokers/dealers, and other participants in the interdealer market. In addition, the size of the FX market has grown as the economy has continued to globalize. The value of transactions that are settled globally each day has risen exponentially—from \$1 billion in 1974 to \$1.9 trillion in 2004.

The increased complexity of the market and higher trade volumes have necessitated constant changes in trading procedures, trade capture systems, operational procedures, and risk management tools.

A number of changes have also affected the FX market more broadly over the last few years. Those changes include

- introduction of the euro,
- increased consolidation of both FX dealers and nostro banks, resulting in marketplace consolidation,
- consolidation of FX processing in global or regional processing centers,
- outsourcing of back office functions,
- introduction of CLS Bank in order to substantially reduce FX settlement risk,
- increased focus on crisis management and contingency planning in the wake of several currency crises and the destruction of the World Trade Center in New York City,
- increased focus on “know your customer” anti-money-laundering efforts and other regulatory requirements to limit access by terrorists to worldwide clearing systems,
- increasing use of web portals for FX transactions,

¹ Bank for International Settlements, *Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity 2004* (Basel: BIS, 2004).

- expansion of prime brokerage, and
- regulatory focus on capital allocations for operational risk.

Developments like these make it crucial that operations, operational technology, and settlement risk management keep pace with the changing FX market.

The History of This Document

In 1995, the Foreign Exchange Committee (the Committee) recognized the need for a checklist of best practices that could aid industry leaders as they develop internal guidelines and procedures to foster improvement in the quality of risk management. The original version of *Management of Operational Risk in Foreign Exchange* was published in 1996 by the Committee's Operations Managers Working Group to serve as a resource for firms as they periodically evaluate their policies and procedures to manage operational risks properly. This update, written in 2003 and amended in 2010, takes into account market practices that have evolved since the paper's original publication and supersedes previous recommendations by the Committee on operational issues.

In addition to this document, the Committee has often offered recommendations on specific issues related to operational risk. Although the best practices here are directed at FX dealers primarily, the Committee has also offered guidance to other market participants. Such guidance is mentioned periodically in the best practices here and may also be found at the Committee's website, <www.newyorkfed.org/fxc/>.

What Is Operational Risk?

Operational risk is the risk of direct or indirect loss resulting from inadequate or failed internal procedures, people, and systems, or from external events.² For the purposes of this paper, we adopt this definition of operational risk put forth by the Bank for International Settlements. However, while reputational risk is not considered part of operational risk for Basel capital purposes, the importance of reputational risk in foreign exchange is reflected in the best practices outlined in this document.

Operational risk for foreign exchange in particular involves problems with processing, product pricing, and valuation. These problems can result from a variety of causes, including natural disasters, which can cause the loss of a primary trading site, or a change in the financial details of the trade or settlement instructions on a FX transaction. Operational risk may also emanate from poor planning and procedures, inadequate systems, failure to properly supervise staff, defective controls, fraud, and human error.³

Failure to adequately manage operational risk, in turn, can decrease a firm's profitability. Incorrect settlement of FX transactions, for example, can have direct costs in improper

² Bank for International Settlements, Basel Committee on Banking Supervision, *Operational Risk Supporting Documentation to the New Basel Capital Accord* (Basel: BIS, 2002), p. 2.

³ Foreign Exchange Committee, "Guidelines for the Management of FX Trading Activities," in *The Foreign Exchange Committee 2000 Annual Report* (New York: Federal Reserve Bank of New York, 2001), p. 69.

payments and receipts. In addition, trade processing and settlement errors can lead to indirect costs, such as compensation payments to counterparts for failed settlements or the development of large losses in a firm's portfolio as a result of managing the wrong position. Furthermore, investigating problems and negotiating a resolution with a counterparty may carry additional costs. Failure to manage operational risk may also harm a firm's reputation and contribute to a loss of business.

Operational risk has another distinctive quality. Unlike credit and market risk, operational risk is very difficult to quantify. Clearly, an institution can measure some of the losses associated with operational errors or losses that result from the failure of the operational process to catch errors made by sales and trading areas. Determining expected losses, however, given the uncertainty surrounding those losses, is much more complicated for operational risks than for other risk categories.

What Are “Best Practices”?

This document offers a collection of practices that may mitigate some of the operational risks that are specific to the FX industry. The implementation of these practices may also help to reduce the level of risk in the FX market more generally. Finally, acceptance of these practices may help reduce operational costs. When robust controls are in place, less time and energy is needed to investigate and address operational problems.

The best practices in this document are already used to varying degrees by the working group members responsible for this paper. Collectively, the working group feels that these are practices toward which all market participants should strive. Therefore, this compilation is meant to provide a checklist for organizations new to the market but it is also designed to serve as a tool for established market participants as they periodically review the integrity of their operating procedures. Each firm is encouraged to take into account its own unique characteristics, such as transaction volume and role in the market, as it makes use of the recommendations. These best practices are intended as goals, not binding rules.

The best practices listed here are recommendations that all parties engaging in FX, regardless of the institution's size or role in the marketplace, should consider adopting for both internal (with the exception of practices that are inapplicable such as credit management and documentation) and external transactions. In addition, it is clear that the larger the participant, the more important it is to implement the recommendations in the most automated manner possible. Smaller participants should make sure that they have appropriate controls in place for any best practice that proves too expensive to automate. Given the differences in the size of firms, it may be helpful to underscore that firms are not bound to integrate all of the recommended practices in this document, but should use them as a benchmark for examining their existing practices.

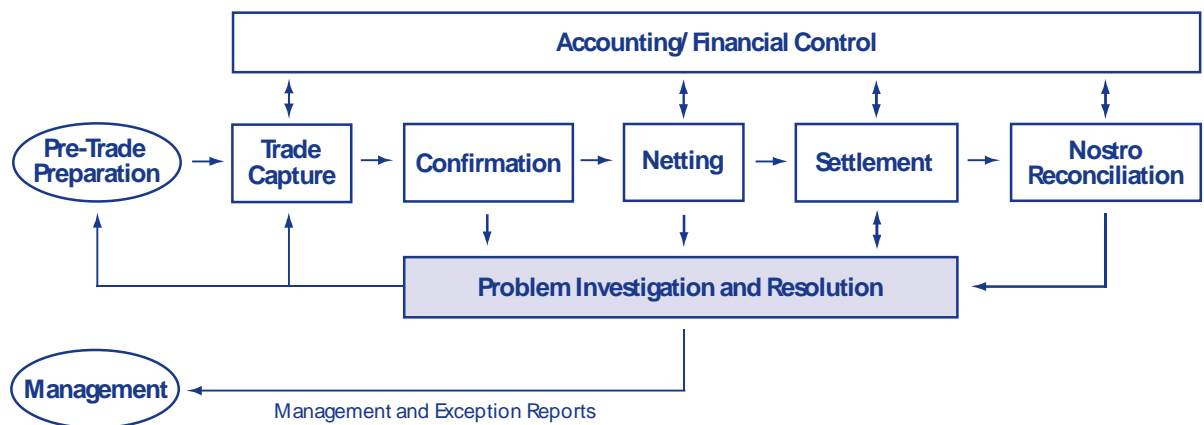
How to Use This Document

This document is divided into sections based on the seven steps of the FX trade process flow 1) pre-trade preparation, 2) trade capture, 3) confirmation, 4) netting, 5) settlement, 6) nostro reconciliation, and 7) accounting/financial control processes. How each of these seven phases integrates with the others in the FX process flow is outlined in Figure 1 below. Each section of this paper provides a process description of the steps involved in the trade phase

discussed in that section, followed by a list of best practices specific to that phase. The paper concludes with a list of general best practices that apply more widely to the overall management of operational risk, including guidance for contingency planning.

This document concentrates on some of the most common areas where operational risk arises in the various stages of the FX process. Often operational errors result from a breakdown in the information flow in the sequential steps of the process. To avoid such problems, it is essential that market participants clearly understand each of the seven stages of FX trade and settlement, and fully comprehend how each phase is related to the larger process flow. A break in the process, especially in the feedback loop, may lead to a breakdown in the flow of information, which in turn increases the potential for financial loss. Proper procedures, including those concerning escalation and notification, should be in place for management to deal with problems wherever they occur in the process flow.

Figure 1
The FX Process Flow



Future Trends

It is important to acknowledge at the outset that the FX business is constantly evolving. Technology continues to advance, trading volume in emerging market currencies continues to increase, new exotic structures are continually introduced, and many institutions are regionalizing their sales and trading and operations areas by creating small satellite offices. Some of the major trends that will continue to affect FX operational risk are as follows:

- Technology continues to advance rapidly, enabling traders and salespeople to execute many more transactions during periods of market volatility.
- Systems are becoming more standardized, and will use new communication formats (for example, XML protocol).
- Trading volume in emerging market currencies continues to grow as many developing nations become more active in international capital markets. This increase in volume is coupled with new and problematic settlement procedures for these currencies.
- Traders and salespeople continue to develop new and more exotic types of transactions, especially in FX derivative products. These require special, often manual, processing by

operations groups until new transaction types can be included in the main processing cycle.

- New types of clients continue to enter the FX market, which require development of new operational procedures.

All of these trends, and many others, will continue to change the industry, eliminating some risks and introducing new ones. It is imperative that management thoroughly understands the operations cycle and best practices surrounding operational risk management to manage risks properly as the FX marketplace continues to evolve.

Definitions of Key Terms

To clarify terms used in this document:

Bank refers here to all market makers in FX, whether commercial or investment banks.

From a bank's viewpoint all deals are conducted with a **counterparty**, which can be another bank, or a corporate, institutional, or retail client. The concepts in this document apply to all such market participants.

Sales and trading refers to the front office. Trading employees execute customer orders and take positions; they may act as a market maker, dealer, proprietary trader, intermediary, or end user. A bank may also have a sales force or marketing staff, which is part of the front office. Salespersons receive price quotes from the bank's trading staff and present market opportunities to current and potential clients.

Operations is used throughout this document when referring to the processing, settlement, back-office, or middle-office areas. Specifically, operations provide support service to sales and trading.

Interdealer refers to trading between market makers.

Nostro bank, correspondent bank, agent bank, and clearing bank are used interchangeably here. A bank may use the services of one or more affiliated or unaffiliated nostro banks to make and receive payments, or it may act as its own nostro bank. Banks generally use a different nostro bank for each currency that they trade.

Vanilla options refers to options that are standard in the industry. In other words, vanilla options are **European style** and expire at an agreed date and time and have no **fixing** or **averaging** of the strike price.

Nonvanilla options generally refer to options that have a fixing or averaging component or are part of a structured (combination) option type, for example, average rate options. Any currency option that is not vanilla is considered nonvanilla, ranging from **American style** options to heavily structured options.

P&L refers to the profit and loss record of a portfolio or transaction.

Prime brokerage describes an arrangement that allows customers to conduct FX transactions (spot, forward, and options) in the name of a bank or “prime broker.” In a typical prime brokerage arrangement, the customer chooses one or two prime brokers to service their account. The prime broker’s responsibility is to set up documentation and procedures that allow the customer to conduct FX transactions directly with several counterparties, but in the name of the prime broker. These executing counter-parties recognize the prime broker as their legal counterparty in such trades. The prime broker enters into equal and opposite trades with the customer and executing counter-parties. Specific procedures are agreed upon among the customer, prime broker, and executing counterparties to effectuate the trading and “give up” relationships. The prime broker typically charges the customer a fee for prime brokerage.

Pre-Trade Preparation and Documentation

Process Description

The pre-trade preparation and documentation process initiates the business relationship between two parties. During this process, both parties’ needs and business practices should be established. An understanding of each counterparty’s trading characteristics and level of technical sophistication should also develop. In summary, the pre-trade process allows both parties to mutually agree on procedures and practices to ensure that business is conducted in a safe and sound manner.

In the pre-trade process, a bank develops an understanding of the inherent business risks and risk mitigants of each of its counter-party relationships. The documentation and agreements reflecting the relationship should be identified and, if possible, executed before trading. Thus, pre-trade preparation involves coordination with sales and trading and operations as well as other support areas such as systems, credit, legal, and compliance to establish trade capture parameters and requirements that should be in place prior to trading. This process is especially important when the business requirements may be unique and require additional controls.

Best Practice no. 1:

Know Your Customer

A bank should know the identity of its counterparties, the activities they intend to undertake with the bank, and why they are undertaking those activities.

All firms should have strong Know Your Customer (KYC) procedures for collecting information required to understand who the customer is and why they are conducting business. KYC procedures have long been the first line of defense for banks in setting appropriate credit limits, determining the most appropriate documentation for the activities being contemplated,

identifying additional business opportunities, and protecting against fraud.

KYC procedures have, more recently, also become the cornerstone for combating criminal activity. Illicit activity has become more sophisticated in the methods used to conceal and move proceeds. The global response has been to develop laws and regulations requiring institutions to establish familiarity with each of their counterparties to better identify and report suspicious activity.

At a minimum, information relating to the identity of a counterparty and the counter-party's activity should be gathered to satisfy applicable laws and regulations for prudent business conduct. The reputation and legal risk to banks of not being vigilant in knowing their customers and complying with KYC laws and regulations can be severe. In the United States, examples of laws and regulations that impose obligations of this sort on banks are the Bank Secrecy Act, money laundering regulations, U.S. Treasury, Office of Foreign Assets Control (OFAC) regulations, and the USA PATRIOT Act.

Best Practice no. 2:

Determine Documentation Requirements

A bank should determine its documentation requirements in advance of trading and know whether or not those requirements have been met prior to trading.

A bank should execute transactions only if it has the proper documentation in place. The types of documentation that may be required include 1) master agreements (see Best Practice no. 3), 2) authorized signatory lists, and 3) standard settlement instructions. Such documents should be routinely checked before executing trades. An institution should also establish a policy on whether or not it will trade, and in what circumstances, without first obtaining a master agreement (for example, IFEMA, ICOM, FEOMA, or the ISDA Master) with a customer covering the transactions. It should also be noted that electronic trading often requires special documentation. Specifically, customer and user identification procedures, as well as security procedures, should be documented.

This recommendation emphasizes the principles of awareness and information with respect to documentation. In practice, it may be difficult to do business with a policy that requires documentation to be in place in every instance. In many cases, the risks of not having a particular piece of documentation may be acceptable. Nonetheless, it is crucial that all relevant personnel 1) know the policy of the institution on documentation, 2) know when the documentation is or is not in place, and 3) be able to produce reports regarding documentation status.

Representatives of the business, operations, credit, legal, and compliance areas, for example, need to establish the institution's policies and document their understanding of these policies in writing. The institution should have adequate tracking systems (manual or other) to determine when policy requirements are satisfied or not. These systems should be able to produce reports necessary for proper contract monitoring.

If the policy of the institution is to have a master agreement in place, the institution should be able to produce a report displaying any missing master agreements. Such reports should classify data by age and be distributed to management. Lastly, there should be escalation and support procedures in place for dealing with missing documentation when normal efforts are not enough to obtain it.

Best Practice no. 3:

Use Master Netting Agreements with Credit Support Annexes Attached

If a bank elects to use a master agreement with a counterparty, the master agreement should contain legally enforceable provisions for “closeout” netting and/or settlement netting.

“Closeout” and settlement netting provisions in master agreements permit a bank to decrease credit exposures, increase business with existing counterparties, and decrease the need for credit support of counterparty obligations.⁴ Closeout netting clauses provide for 1) appropriate events of default, including default upon insolvency or bankruptcy, 2) immediate closeout of all covered transactions, and 3) the calculation of a single net obligation from unrealized gains and losses. Closeout provisions have the added benefit of a positive balance sheet effect under Financial Accounting Standards Board (FASB) Interpretation 39, which allows the netting of assets and liabilities in the unrealized gains and losses account if netting is legally enforceable in the relevant jurisdiction.⁵

Closeout netting provisions help to protect a bank in the event of a counterparty default. When a counterparty defaults, and a closeout netting agreement is not in place, the bankruptcy trustee of the defaulting party may demand payment on all contracts that are in-the-money and refuse to pay on those where it is out-of-the-money. If the defaulting counterparty takes this action, the non-defaulting party may be left with a larger than expected loss. A master agreement signed by both parties with enforceable closeout netting provisions ensures that the counterparty remains responsible for all existing contracts and not just those it chooses to endorse.⁶

Settlement netting permits parties to settle multiple trades with a counterparty with only one payment instead of settling each trade individually with separate payments. Consequently, settlement netting decreases operational risk to the bank in addition to reducing settlement risk. To realize the settlement netting benefits, however, a bank’s operations function must commence settling on a net basis. Therefore, it is essential that operations receive a copy of the agreement or be notified of the terms of the executed agreement. Given the benefits of

⁴ U.S. Comptroller of the Currency, *Banking Circular 277* (Washington, D.C.: GPO, 1993), p. 22.

⁵ Financial Accounting Standards Board, FASB Interpretation No. 39: Offsetting of Amounts Related to Certain Contracts: An Interpretation of APB Opinion No. 10 and *FASB Statement No. 105*, (FASB, March 1992), and *FASB Statement No. 105*: Disclosure of Information about Financial Instruments with Off-Balance-Sheet Risk and Financial Instruments with Concentrations of Credit Risk, (FASB, March 1990).

⁶ Group of Thirty, Global Derivatives Study Group, *Derivatives: Practices and Principles* (Group of Thirty, 1993), p.16.

settlement netting, it is in a bank's best interest to include settlement netting in any master agreement that it may enter into.

The following master agreements have been developed as industry-standard forms. Each form includes provisions for settlement netting (included as an optional term) and closeout netting:

- ISDA Master Agreement,
- IFEMA Agreement covering spot and forward currency transactions,
- ICOM Agreement covering currency options,
- FEOMA Agreement covering spot and forward currency transactions and currency options.

These netting provisions should satisfy relevant accounting and regulatory standards as long as legal opinions are able to conclude that the agreements are legally enforceable in each jurisdiction in which they are applied. Banks should confer with local legal counsel in all relevant jurisdictions to ensure that netting provisions are enforceable. To the extent that local counsel suggests that certain provisions of a master netting agreement may be unenforceable, the bank should ensure that other provisions in the agreement could be enforced nonetheless.

A credit support annex (CSA) can also be negotiated as a supplement to these master netting agreements. CSAs provide for the movement of collateral between parties during the term of outstanding transactions governed by the master netting agreement in order to reduce the net exposure that may result in the event of a trading counterparty's bankruptcy or other default under such agreement. Under a CSA, one or both parties agree to post collateral to secure counterparty credit exposure, typically on a net basis. Under these CSAs, failure to deliver required collateral also constitutes an event of default under the master netting agreement.

There may be two components to any collateral arrangement. The primary component is a requirement to deliver collateral based on the net mark-to-market valuation of all transactions documented under the master agreement, or "variation margin." In the case of the ISDA CSA, variation margin is determined based on mid-market values for the transactions and does not reflect the bid or offer spread that would result in replacing the transactions in an actual default of one of the parties. Variation margin is calculated at mid-market in order to avoid one party being preferred over the other as a result of calculating the mark-to-market value of transactions at that party's side of the market (which would include bid or offer, as applicable). Variation margin is most commonly calculated based on the previous day's closing marks and is delivered on a daily basis to the party that has the net receivable in the event of a closeout of the transactions.

The other component to the collateral requirement is commonly referred to as "initial margin" (or "Independent Amount," the term used in the ISDA CSA). The purpose of this collateral requirement--which may be defined for specific transactions, a portfolio of transactions, or all transactions governed by the relevant master agreement, either in the credit support document or in transaction confirmations--is to provide additional cushion beyond the mark-to-market exposure. In cases where a party's trading partner is in default, the initial margin serves as a buffer to protect against market movements in transaction values during the time between the last variation margin delivery and the date on which the non-defaulting party can actually close

out positions and apply collateral or when a bid-offer spread is applied in order to determine replacement value.

Best Practice no. 4:

Agree upon Trading and Operational Practices

Trading and operational practices should be established with all counterparties.

Most banks reach an understanding with all counterparties as to the type of business they will be transacting and how they should interact. Banks should include key operational practices such as providing timely confirmation or affirmation, the use of standing settlement instructions (SSIs), and timely notification of splits.

The level of trading activity with fund managers and investment advisors has escalated in recent years. These clients transact in block or bulk trades, which are then split into smaller amounts and entered into specific client accounts managed by fund managers or investment advisors. Until a block or bulk trade is properly allocated to the specific accounts of each fund entity, inaccurate credit risk management information may exist.

The understanding should clearly establish confirmation and settlement procedures for all counterparties and delineate both the bank and client's obligations in the process flow. A bank should strongly encourage clients to confirm bulk trades as soon as possible after the trade is executed.⁷ In addition, a bank should request that fund managers provide them with the "split" information on the trade date for all trade types (spot, forwards, swaps, tom/next, etc.) regardless of maturity, so that the bank's credit information can be updated as soon as possible.

Best Practice no. 5:

Agree upon and Document Special Arrangements

If, in the course of the documentation set-up and establishment of trade and operational practices, it becomes clear that a counterparty requires special arrangements—such as third-party payments or prime brokerage service—those arrangements should be agreed upon and documented in advance of trading.

Counterparties at times may request third-party payments to facilitate underlying commercial transactions. Third-party payments are the transfer of funds in settlement of a FX transaction to the account of an entity other than that of the counterparty to the transaction. However, third-party payments raise important issues that need to be closely considered by an organization engaged in such practices.

Firms should recognize that third-party payments cause a significant increase in operational risk. Since the identity and entitlement of the third party is not known to the bank, extreme care should be taken in verifying payment instructions to third parties. Regulatory requirements such as the USA PATRIOT Act, OFAC, and the Bank Secrecy Act should also be applied to third parties. Both the counterparty and bank management should be aware of the risks involved with these transactions and should establish clear procedures beforehand for validating both the

⁷ For further information, see Best Practice no. 21, Confirm All Block Trades and Split Allocations.

authenticity and correctness of such requests.

Prime brokerage arrangements may also involve special occasions for misunderstanding the respective rights and obligations of the various parties. Such arrangements should be evidenced by written agreements (prime broker and dealer, prime broker and customer, dealer and customer) that have been reviewed and approved by legal counsel.

Trade Capture

Process Description

The trade capture function is the second phase of the FX processing flow. Deals may be transacted directly over a recorded phone line, through a voice broker, via an electronic matching system (for example EBS and Reuters), or through Internet based systems (for example, proprietary trading systems or multidealer trading platforms).

After the deal is executed, the trader, or trader's assistant, inputs trade data into the front-office system or writes a ticket to be entered into a bank's operations system. Deals done over electronic dealing systems such as Reuters or EBS allow deal information to flow electronically to the front-office system. Trade information typically includes trade date, time of trade, settlement date, counterparty, financial instrument traded, amount transacted, price or rate, and may include settlement instructions.

The system used in the front-office processes this information and can provide "real-time" position and profit and loss updates. Trade information captured in the front office system flows to the credit system where settlement risk and mark-to-market (also referred to as pre-settlement) credit risk measures and limits are updated.

Trade information from front-office systems flows through to the operations system, where it is posted to sub-ledger accounts, and the general ledger is updated as trades are processed. Operations staff should be responsible for ensuring that appropriate settlement instructions are captured so that the required confirmation message can be issued. For interbank, institutional, and corporate counterparties with Standard Settlement Instructions (SSIs) on file, the deal is immediately moved to the confirmation process.

However, if SSIs are overwritten or not in place, operations staff must obtain settlement instructions from the counterparty or confirm the settlement instructions received by sales and trading. For forward trades that are not settled until sometime in the future, operations staff may contact the counterparty at a later date for settlement instructions. The financial details of the deal, however, must be confirmed on the trade date. If deals need to be amended, changes should be implemented in a controlled manner involving both sales and trading and operations.

Fund managers and investment advisors frequently trade for more than one underlying fund or counterparty at once. Typically, they transact a single "block" or "bulk" trade, which they then "split" into a series of smaller trades as they allocate the block trade to the underlying funds or counterparties. Operations staff needs to receive split information soon after trade execution to

issue confirmations for each of the split transactions.

Inaccurate or untimely trade capture can have implications for P&L and risk management for a bank. If a bank does not capture the correct transaction, then its positions and reported credit exposure will be incorrect.

Best Practice no. 6:

Enter Trades in a Timely Manner

All trades, external and internal, should be entered immediately and be accessible for both sales and trading and operations processing as soon as they are executed.

It is crucial that all trades are entered immediately so that all systems and processes are provided with timely, updated information. No matter how sophisticated the system, data may not be accurate if users enter it incorrectly or delay its entry. For that reason, it is important to ensure that the duties of trade entry are appropriately segregated. Front-end systems that capture deal information may interface with other systems that monitor and update the following:

- credit limit usage,
- intra-day P&L,
- trader positions,
- confirmation processing records,
- settlement instructions, and
- general ledger activity.

A bank's ability to manage risk may be adversely affected if it does not have accurate transaction updates in each of the above areas. Inaccuracies in each category not only erode a bank's profitability, but may also tarnish a bank's reputation. In the event of a settlement error, for example, the bank must pay compensation costs to the counterparty and cover short cash positions. Moreover, incorrect financial statements arising from problems in general ledger data can harm the reputation of the bank. Further, if credit positions are not properly updated, the bank may take on more risk to a counterparty, industry, or country than would be prudent.

In addition, it is important to note that internal trades should be subject to the same degree of diligence as external trades in terms of timely entry because they carry the same risks (with the exception of credit risk).

Best Practice no. 7:

Use Straight-Through Processing

When sales and trading and operations use separate systems, electronic feeds should automatically feed all deals, adjustments, and cancellations from one system to the other. Ideally, the transaction data should also be carried straight-through for posting to the general ledger, updating credit information, generating money transfer instructions, and feeding nostro reconciliation systems.

To ensure timely processing by operations and eliminate potential errors that can occur if trades are reentered into the operations systems, straight-through processing should exist between sales

and trading and operations. Such a link should move deals, adjustments, and cancellations to the operations system as soon as sales and trading finalizes them. This transaction data—also passed straight through to other systems in the institution—will further decrease potential errors that can occur when information is manually keyed into systems. This practice also improves the timeliness of the data.

Most brokered transactions are now executed over automated broker systems. Therefore, straight-through processing links from these systems into sales and trading should also be implemented when volume warrants.

Best Practice no. 8:

Use Real-Time Credit Monitoring

Credit lines and usage information should be updated as soon as deals are entered, and the information should be accessible to sales and trading and risk managers. A bank should establish real-time credit systems to calculate and aggregate exposures globally across all trading centers.

A bank should execute transactions only if credit lines have been approved and are available for a designated counterparty. No trade should be finalized without confirming the availability of sufficient credit. Electronic broker credit prescreening schemes are preferable to the practice of brokers switching counterparties. In the event of default by a counterparty, a bank could lose the positive market value of the positions it has with the defaulting party or, if default occurs in the middle of settlement, it could lose the entire principal of the deal.

A sales and trading area should be able to quickly assess its institution's credit exposure to its counterparties globally. These exposures should be communicated in real-time to the trading system. The system should take into account changes in static credit lines for electronic trading platforms that periodically may have to be updated or revised. The system should also automatically update a counterparty's credit status when the counterparty deals with the bank on a global aggregate basis. This requires straight-through processing from the trade capture system to a real-time credit system.

Sales and trading should see the effects of a deal on a counterparty's credit status immediately, and that unit should know when a counterparty's credit limit is close to being filled and be prevented from dealing with counterparties who have reached or exceeded such limits. Sales and trading and credit management should produce reports of credit line excesses and exceptions on a regular basis for review. Exception reports should identify both counterparties involved and the sales and trading personnel executing the transactions.

Real-time credit systems also allow a bank's credit managers to assess the credit exposure to a counterparty throughout the life of a transaction. Credit officers are better able to manage crisis situations and to adjust limits as the creditworthiness of a counterparty changes. A real-time credit system ensures that any changes in the credit limit of a counterparty are reflected in the sales and trading system immediately.⁸

⁸ U.S. Comptroller of the Currency, *Banking Circular 277* (Washington, D.C.: GPO, 1993).

Best Practice no. 9:

Use Standing Settlement Instructions

Standing Settlement Instructions (SSIs) should be in place for all counterparties. Market participants should issue new SSIs, as well as any changes to SSIs, to each of their trading partners in a secure manner. For banks, the preferable method is through an authenticated medium such as SWIFT messages.

SSIs allow for complete trade details to be entered quickly, so that the confirmation process can begin as soon after trade execution as possible. In general, when SSIs are in place, it is possible to take full advantage of straight-through processing because operations may not have to manually intervene in the transaction during the settlement process. SSIs also allow for payments to be formatted properly and for readable SWIFT codes to be issued. If SSIs are not established, operations must contact the counterparty to obtain settlement instructions and the deal record must subsequently be changed to reflect these settlement instructions. The extra work involved in inputting, formatting, and confirming settlement instructions increases the opportunity for errors in settlement, making SSIs important for risk management and efficiency.

Institutions should update their records promptly when changes to SSIs are received from their counterparties. When an institution changes its SSIs, it should give as much time as possible—a minimum of two weeks' notice—to its counterparties so that they can update their records before the date that the new SSIs become effective. A bank should periodically review the SSIs that it has on file.

SSIs for forward transactions can change between the time a deal is confirmed and the time it finally settles. Consequently, a bank should either reconfirm all settlement instructions for forward deals before settlement, or it should reconfirm all outstanding deals whenever SSIs are changed.

SSIs should be in a SWIFT/ISO format to facilitate reference data maintenance and to eliminate the potential for errors in translation. Any deal record with exceptions to an existing SSI should be processed using the same procedures as for nonstandard settlement instructions.

Best Practice no. 10:

Operations Should Be Responsible for Settlement Instructions

Operations should be responsible for ensuring that settlement instructions are collected and confirmed. If no SSIs are in place, operations should be responsible for obtaining and verifying the instructions.

Although SSIs are preferred, they are not always available, and at times SSIs may not be appropriate for all trades. When SSIs are not used, the settlement instructions may be recorded at the time that sales and trading conducts the trade. These exception settlement instructions should be delivered by the close of business on the trade date (if spot) or at least one day prior to settlement (if forward). Nonstandard settlement instructions should be exchanged electronically if possible and should be checked by operations when the trade is confirmed. By taking responsibility for settlement instructions, operations serve the role of an independent

control on sales and trading activity.

Best Practice no. 11:

Review Amendments

Amendments to transaction details should be conducted in a controlled manner that includes both sales and trading and operations in the process. Particular care should be taken for amendments to FX swap transactions after the settlement of the near leg.

If incorrect information was captured in deal entry, certain trades will need to be changed or canceled after they have been released to operations. Mistakes occur when a trader or salesperson enters the wrong counterparty for a deal, an incorrect value date or rate, or makes other data errors.

Although either operations or sales and trading staff can initiate amendments and cancellations, both sales and trading and operations should be involved in the process to maintain proper control. It is imperative, however, that the duties related to processing amendments and cancellations are clearly segregated between operations and sales and trading. This segregation of duties is one of the key control mechanisms of any institution.

The specific process for handling amendments and cancellations will vary from firm to firm and is often dictated by system constraints. However, if operations staff is responsible for amending or canceling a deal, it should obtain supporting documentation and receive prior written authorization from sales and trading before processing the amendments or cancellations. Exception reporting on amendments and cancellations should be made available to sales and trading and operations management regularly. The criteria used for reporting and the frequency of distribution will vary by firm.

Amendments to swap transactions may present difficulties for a bank if the near leg has already settled. When the swap or outright is initially entered into the system, traders cover any resulting currency and interest rate exposure by entering into offsetting deals. The offsetting deals also need to be amended if the swap is entered incorrectly, which may affect P&L. Because the near leg has settled, it cannot be changed to reflect P&L differences. Thus, amendments to swaps should be made with care so that resulting positions and P&L are accurate.

Best Practice no. 12:

Closely Monitor Off-Market and Deep-in-the-Money Option Transactions

All dealer institutions that permit requests for Historical Rate Roll-overs (HRRs) should have written procedures to guide their use and should detail the added controls required in the trading and reporting of off-market transactions. Operational responsibilities should be clearly defined in regard to monitoring, reporting, and special confirmations, if any are needed. Such special confirmations may be necessary to identify the market forward rate in effect when the HRR was executed. The sale of deep-in-the-money options warrants special attention and specific procedures applicable to sales and trading staff (and, if necessary, senior management).

Historical rate rollovers involve the extension of a forward foreign exchange contract by a dealer on behalf of a customer at an off-market rate. As a general rule, all transactions are executed at current market rates. However, at times commercial considerations may dictate otherwise. For more information, see The Foreign Exchange Committee Annual Report 2000, “Guidelines for the Management of FX Trading Activities,” p. 74, and The Foreign Exchange Committee Annual Report 1995, “Letter on Historical Rate Rollovers.”

The sale of deep-in-the-money options warrants special attention and specific procedures applicable to sales and trading staff (and, if necessary, senior management). There may be legitimate reasons for the sale of such options—for example, the “sell back” of an option or the implied delta within a separate derivatives product. However, it should also be recognized that the sale of deep-in-the-money options can be used to exploit weaknesses in a counterparty's revaluation or accounting process that could create erroneous results. Procedures should ensure an appropriate level of review—if necessary, by senior trading management or risk management outside the sales and trading area—to guard against potential legal, reputational, and other risks.

Confirmation

Process Description

The transaction confirmation is legal evidence of the terms of a FX or a currency derivative transaction. Therefore, the management of the confirmation process is an essential control. This process is handled in many ways within FX markets. For vanilla spot, forward FX, or currency option transactions, counterparties exchange electronic or paper confirmations that identify transaction details and provide other relevant information. For structured and nonstandard transactions (non-deliverable forwards [NDFs] and currency option transactions), documents are prepared and 1) exchanged and matched by both counterparties, in the case of most dealers, or 2) signed and returned in the case of certain clients or counterparties.⁹ In either case, it is the market practice to verbally confirm (on a recorded line) the primary economic details of an NDF or exotic currency option transaction between the two counterparties on the day the transaction is executed. Notwithstanding the fact that trades are verbally confirmed, it is still important that a hardcopy confirmation is sent and that the means of such delivery is agreed between the parties.

Given the significance of the confirmation process, it is important that the process is handled independently of the trading room. In most institutions, the operations department performs this activity. Any exceptions to sending confirmations to clients should be reviewed and approved by compliance or legal personnel, and business and operations management.

Exchanging confirmations is essential for mitigating risk in the FX markets. Therefore, outgoing confirmations should be dispatched to the counterparty at the earliest possible opportunity. It is also the responsibility of both counterparties to actively match and validate their own transaction records of incoming electronic or verbal confirmations with counterparties by the end of the business day on the trade date. For some non-vanilla trades, a same day confirmation may cover some specific financials, but a complete long-form confirm may follow

⁹ Typically the price maker prepares the confirmation and the price taker signs the confirmation.

at a later date with nonfinancial information.

Confirmations should be transmitted in a secure manner whenever possible. In the most developed markets, confirmations are generally sent via electronic messages through secure networks. In some instances, proprietary systems have been developed to provide access to confirmations to clients. However, a significant number of transaction confirmations are also sent via mail, e-mail, and fax. It is important to note that when these open communication methods are used there is a greater risk of fraudulent correspondence.

A transaction confirmation should include all relevant data that will allow the two counterparties to accurately agree to the terms of a transaction. All relevant settlement instructions for each transaction should be clearly identified in each confirmation. All confirmations should either be subject to the 1998 FX and Currency Option Definitions issued by the Foreign Exchange Committee, Emerging Markets Traders Association (EMTA), and International Swaps and Derivatives Association (ISDA), or be subject to other appropriate guidelines, and should reference a bilateral master agreement—if one exists between the parties.

Foreign exchange trades are executed in multiple ways, including by phone (direct), voice brokers, electronic dealing platforms, and electronic brokers. As an increasing number of FX transactions are being executed through secure electronic platforms (for example EBS, Reuters) or online electronic dealing platforms, some counterparties have chosen, on a bilateral basis, to eliminate traditional confirmation messages with one another in lieu of electronic affirmation facilities offered by electronic trading systems. These facilities allow operations to review trading system data and validate trade details.

Market participants can affirm that the trade details reflected in the electronic trading system correspond to their own internal books and records. It is important to note, however, that such validation exercises are not equivalent to traditional confirmation messaging because they do not confirm that trade details have been correctly entered into the books and records of each counterparty.¹⁰

Some transactions between banks are also executed via voice brokers. These bilateral transactions should be checked against the broker advice that is typically received on the trade date from the voice broker. Similarly, in the case of FX prime brokerage relationships, these same procedures should be followed in a timely manner by all three participants. It is important to note that broker confirmations are not bilateral confirmations between the principals of the trade and therefore do not carry the weight of a bilateral confirmation.

When trades are not confirmed, exposure to market risk arises. To mitigate this risk, standard escalation procedures should be in place to pursue and resolve all discrepancies in a timely manner. Operations staff is responsible for reporting all unconfirmed trades and unmatched incoming con-firmations to sales and trading. When necessary, the taped phone conversation or

¹⁰ For further guidance on electronic validation and affirmation, see Foreign Exchange Committee, “Supplementary Guidance on Electronic Validations and Confirmation Messaging,” in *The Foreign Exchange Committee 2001 Annual Report* (New York: Federal Reserve Bank of New York, 2002).

the log from the electronic execution system can be used to resolve the discrepancy. Once the problem has been identified, the counterparty with the error should correct the affected deal in its system and issue a corrected confirmation.

Best Practice no. 13:

Confirm and Affirm Trades in a Timely Manner

Both parties should make every effort to send confirmations, or positively affirm trades, within two hours after execution and in no event later than the end of the day. This guideline applies to trades executed with both external and internal counterparties. Any exception to this rule should be clearly documented and approved by operations management and compliance staff.

Prompt confirmations are key to the orderly functioning of the marketplace because they minimize market risk and minimize losses due to settlement errors. In order for confirmations to be timely and accurate, they should be formatted based on trade data captured in the bank's operations system. In order to ensure that confirmations are accurate, they should be generated and sent directly from the operations system to the counterparty without passing through any other internal departments. Senior operations management and compliance staff must approve any exceptions.

Counterparties should either send out their own confirmations, or sign and return (affirm) incoming confirmations. Under no circumstances should either party simply accept receipt of the counterparty confirmation as completion of the confirmation process.

Data included in the confirmation should contain the following: the counterparty to the FX transaction; the office through which they are acting; the broker (if applicable); the transaction date; the value date; the amounts of the currencies being bought and sold; the buying and selling parties; and settlement instructions.

These procedures are meant as practices for executions directly between two parties. In the case of prime brokerage relationships, (in which one financial institution extends its credit to a third party dealing with the institution's customer), confirmations should be exchanged among the three parties in addition to the fulfillment of other requirements for exchanging information. Prime broker relationships alter the control procedures employed with direct dealing; therefore, the prime broker should consider incorporating processes to ensure that communication of notice of execution is correct.

Best Practice no. 14:

Be Diligent When Confirming by Nonsecure Means

A procedure should be in place to call back a counterparty any time the confirmation process occurs via nonsecure media.

Various communication media are currently used for the confirmation process, including fax, mail, and secure electronic messaging such as SWIFT. Authenticated electronic messaging is the most secure means of transmitting confirmations. When other communication media are used, various risks are introduced, ranging from human error to possible fraudulent correspondence. When employing open communication systems, especially mail platforms, this

risk increases. There is a direct correlation between the openness of communication links and the possibility of fraudulent actions.

It is recommended that a bilateral agreement that includes a callback procedure be established when any unauthenticated electronic message system is used. This procedure should include the callback to an authorized individual other than the individual who sent the nonsecure confirmation. This conversation should be done on a recorded telephone line and properly noted.

Best Practice no. 15:

Be Diligent When Confirming Structured or Nonstandard Trades

Special care must be taken when confirming the details of structured transactions or nonstandard trades that cannot be confirmed by a bank's normal procedures or processes. Whenever possible, standard confirmation formats should be used. These formats should identify the calculation agent, special rights and responsibilities assigned to each counterparty, and special instructions on pricing sources, if any.

Structured transactions, including non-deliverable forwards (NDFs), often contain unique features such as special pricing or settlement conventions. Trade details may also assign responsibilities to each counterparty by identifying the calculation agent or the confirming party. Every feature of the trade detail affects the valuation of the trade. Consequently, the price, price source, calculation agent, and confirming party must be carefully validated.

Currently, the standard SWIFT confirmation format cannot accommodate all the unique features of structured trades. Confirmations supporting these transactions are often manually prepared, transmitted by fax, and manually matched against accounting records. Because of the complexity of these trades, and the fact that they are often manually confirmed, there is a significant risk that the confirmation process may fail to detect errors or omissions.

Unlike standard trades, confirmations for structured transactions are usually provided by a calculation agent or jointly between two calculation agents. It should be clear which of the two counterparties is acting as calculation agent (or joint calculation agent status should be indicated). Additionally, the roles and responsibilities of the calculation agent or joint agents should be specified. The calculation agent may also have certain rights and obligations related to price observations and confirmations. These rights should be clearly identified in the text of the confirmation or in the trade contract.

Standardizing the confirmation process can substantially reduce the operational risk associated with this process. Every effort should be made to use the standard confirmation formats outlined by the FX Committee, the Emerging Markets Traders Association (EMTA), and the International Swaps and Derivatives Association (ISDA). Not only should these formats be employed, but every confirmation should also clarify when nonstandard price sources, disruption events, expiration times, or any other nonstandard elements of a trade are introduced.

Best Practice no. 16:

Be Diligent When Confirming by Telephone

Extra care is necessary when confirming trade details by telephone. Phone confirmations should be conducted over recorded lines between appropriate individuals. Following the telephone confirmation, both parties should exchange and match a written or electronic confirmation via fax, mail, SWIFT or secured electronic means such as SWIFT.

Not all trades can be fully confirmed electronically; some structured trades are one example. In addition, some counterparties do not have the ability to confirm trades electronically on the trade date. In such instances, the most common method of confirming transactions is by telephone. However, telephone confirmations are the least reliable method for confirming trades and prone to errors. When using this method, attention to detail and clarity must be emphasized.

Operations should aim to complete phone confirmations within two hours from trade execution, and in no event later than the end of the day. It is imperative that these conversations are conducted over recorded telephone lines. The confirmation conversation should also take place between appropriate individuals only. All relevant information, financial details, and settlement instructions should be confirmed. Following the telephone confirmation, both parties should record the date, time, telephone line, and the name of the individual with whom the trade was confirmed. In addition to the telephone confirmation, both parties should exchange and match a formal (mail, SWIFT, or other electronic) confirmation or a callback procedure should follow.

Best Practice no. 17:

Institute Controls for Trades Transacted through Electronic Trading Platforms

If two parties bilaterally choose to validate trade data against an electronic front-end trading system in place of exchanging traditional confirmation messages, both parties should ensure that trade data flows straight through from the front-end system to their respective operations systems. Strict controls must be in place to ensure that the flow of data between the two systems is not changed and that data is not deleted.

Issuing traditional confirmations is always considered a best practice from a risk perspective because they reflect the books and records of both counterparties. However, firms with well-established controls and straight-through processing may consider a bilateral agreement with a counterparty to accept validation of trade data over a secure electronic platform to constitute a legally binding confirmation, if the recorded trade details are deemed sufficient to validate the trade terms. Only institutions that have direct feeds from dealing systems all the way through their operations systems, however, should employ this exception process and consider this acceptable as an alternative to traditional confirmations.

Best Practice no. 18:

Verify Expected Settlement Instructions

A bank should include its own settlement instructions as well as the settlement instructions of its counterparty on confirmations. Upon receipt of a confirmation, firms should systematically check both parties' settlements instructions and ensure that they coincide with those agreed upon at trade capture.

It is in the best interest of a bank to send its own settlement instructions to counterparties. This step provides counterparties with written confirmation of the settlement instructions and can

help reduce mistakes and the possibility of fraud.

Similarly, if a bank receives settlement instructions on an inbound confirmation, the bank should check that the instructions match the instructions included in the trade agreement. It is best to discover and correct errors in settlement instructions before payment instructions are issued in order to reduce the incidence of error for both parties.

Best Practice no. 19:

Confirm All Netted Transactions¹¹

All transactions, even those that will be netted, should be confirmed individually.

Netting trades for settlement is an important operational function because it allows a bank to reduce settlement risk and operational cost. However, it is still necessary to confirm all transactions individually. If netted trades are not confirmed individually, trades may be mistakenly added or removed from the net agreement, which will be difficult to detect on settlement day. Incorrect netting will distort credit and settlement risk. It may also cause losses to a bank if it must pay gross amounts instead of netted amounts or if it has to cover overdrafts resulting from incorrect settlement. The confirmation of these deals should be performed as it would be in any other transaction or with the aid of a netting service provider.

Best Practice no. 20:

Confirm All Internal Transactions

Internal transactions should be subject to the same procedures as those in place for external clients. Internal counterparties should confirm or affirm transactions as if they transacted a deal with external counterparties.

Quite often, operations and management relax their control procedures when executing internal deals. In some cases, confirmations are not sent to the internal counterparty, and not affirmed by the receiving internal counterparty. However, when confirmations are not properly issued and affirmed, trade details are not verified, and a greater probability of error results.

A bank should recognize that deals done with internal counterparties are not immune from errors. Lack of confirmations will prevent the timely recognition of trade errors, thereby increasing the risk of settlement mistakes or incorrect funding. Consequently, a bank should issue confirmations and should abide by the standard confirmation process for all internal counterparties to preserve controls and risk management procedures.

If multiple systems are used by an institution, then the confirmation process should be automated across those systems. In institutions in which only one system is used across internal counterparties, a process should be set up within that system to insure that both sides of the transaction are properly recorded and matched.

¹¹ Additional recommendations for netting trades can be found in Foreign Exchange Committee, “Guidelines for FX Settlement Netting,” in *The Foreign Exchange Committee 1996 Annual Report* (New York: Federal Reserve Bank of New York, 1997).

Best Practice no. 21:

Confirm All Block Trades and Split Allocations

When block trades combine several split trades, the full amount of the block trade should be confirmed within two hours of the trade. All allocations for split trades should be confirmed separately within four hours and no later than the end of the business day on the trade date. Sub-account allocations are necessary to evaluate not only credit exposure but also potential regulatory compliance.

In recent years, the use of block (or bulk) trades has increased as trading with fund managers and investment advisors has grown. Such fiduciaries combine several client trades into larger block trades that are then allocated to the fiduciary's specific clients. Until a block is properly allocated to the specific client, inaccurate credit risk management information may exist. Banks should use particular caution when establishing practices for block trades.

Although confirmations of block trade, by themselves, reduce a bank's market risk, confirming only the block trade does not provide the essential customer data for the firm's credit and compliance systems. For a bank to fully understand its counterparty risk, all deals must be confirmed at the split (counterparty) level.

The recommended best practice is to send these confirmations via electronic messages through secure networks within four hours and no later than the end of the day on the trade date. A bank should require that fund managers provide them with the allocation information on the trade date for all trade types regardless of maturity, so that the bank's credit information can be updated as soon as possible.

Best Practice no. 22:

Review Third-Party Advices

Banks should confirm trades conducted through a broker directly with one another. Review of Reuter's logs, EBS trade tickets, and voice broker advices should not serve as the primary method of bilateral confirmation. These logs and advices should be treated as a third-party verification of trade information.

Bilateral confirmations are written statements of all the essential economic terms of a transaction. Reuters logs and EBS trade tickets are effective ways for operations to review trade information captured in the operations system, and to verify that the economic terms, including settlement instructions, of the trade were properly captured in the risk and confirmation systems of the firm.

However, Reuter's logs, EBS trade tickets, and voice broker advices do not ensure that the counterparty has captured the correct trade information in its operations systems. Therefore, institutions should not rely solely on an incoming broker advice. As the contract binds the two principals to the transaction, direct and timely bilateral confirmations should be exchanged between the two counterparties for every transaction. If a firm does not receive a bilateral confirmation from its counterparty, then it should review with its legal counsel whether the counterparty is bound to the terms and agreement of the deal as documented by the broker

advice.

As stated in the process description that begins this section, institutions that have direct feeds from secure electronic platforms (for example EBS, Reuters) and that in addition pass straight through to the operations systems may consider bilaterally agreeing to eliminate any further exchange of confirmation on these transactions.

Best Practice no. 23:

Automate the Confirmation Matching Process

*Electronic confirmation matching and tracking systems should be adopted as standard operating procedures.*¹²

Electronic confirmation matching requires that two parties agree to electronically match their confirmations through an in-house proprietary system or a third-party vendor. Electronic confirmation matching is the most reliable method of confirming transactions. Such matching decreases market risk and trade errors, minimizes settlement and compensation payments, and reduces operational and overhead costs. Electronic confirmation matching allows a bank to increase the volume of transactions confirmed in a timely manner.

The confirmation process should be additionally controlled by establishing an automated confirmation tracking and follow-up system. Such a system will decrease the chances that deals are not settled properly and help management track and escalate nonconfirmation. Moreover, automating confirmation tracking and follow-up enables a bank to identify counterparties that do not confirm on a regular basis so that they can be addressed. Finally, automation, as opposed to a purely manual system, decreases potential errors caused by human intervention (phone and paper) and reduces operational costs.¹³

Best Practice no. 24:

Establish Exception Processing and Escalation Procedures

Escalation procedures should be established to resolve any unconfirmed or disputed deals. Periodic reports containing transactions that have not been confirmed or affirmed, and counterparties that do not confirm or affirm, should be issued to sales and trading and senior management.

Exposure to market risk arises when trades are not confirmed. To mitigate this risk, standard escalation procedures should be in place to pursue and resolve all discrepancies in a timely manner. Unconfirmed deals may indicate trade entry errors, such as a failure to enter the trade, or that a counterparty did not recognize a trade. Repeated problems may indicate that the counterparty does not execute operational procedures correctly, which may signal the need to reevaluate the trade relationship.

¹² Foreign Exchange Committee, “Standardizing the Confirmation Process,” in *The Foreign Exchange Committee 1995 Annual Report* (New York: Federal Reserve Bank of New York, 1996).

¹³ Foreign Exchange Committee, “Standardizing the Confirmation Process,” in *The Foreign Exchange Committee 1995 Annual Report* (New York: Federal Reserve Bank of New York, 1996).

Internal procedures should be established to monitor unconfirmed trades. When a confirmation is received from a counterparty, and no record of the deal exists internally, operations should immediately establish whether a deal has in fact been conducted by contacting the appropriate person in sales and trading. Operations should then verify the trade information from a related source (for example, Reuters conversation or broker confirmation) or by contacting the counterparty directly. In either case, operations needs to follow escalation practices regarding unconfirmed trades as outlined by the firm. Under no circumstances should a dispute be carried over for more than one day after the trade date, and if such a dispute should arise, it should be carried over only with the approval of senior management.

Escalation procedures should also include notification to sales and trading so that they know which counterparties do not comply with best practices. Senior management should also be informed of unconfirmed deals so that they can evaluate the level of operating risk being introduced by maintaining dealing relationships with noncompliant counterparties. Compensating controls—such as sending out periodic statements with all outstanding forward trades—can be implemented, but it must be recognized that such controls do not eliminate the risks inherent with unconfirmed trades.

The segregation of duties between sales and trading and operations can pose special challenges when dealing with exceptions. Under no circumstances should operations concede control of unconfirmed trades to sales and trading. If confirmations are received that operations does not recognize, it is imperative that operations maintain control of such confirmations until either a cancellation or amendment is received. When trades remain unconfirmed, escalation procedures should be strictly followed and senior operations management should formally review any exceptions to policy.

Netting

Process Description

Bilateral settlement netting is the practice of combining all trades between two counterparties due on a particular settlement date and calculating a single net payment in each currency. If, for example, a bank does twenty-five trades in dollar-yen with the same counterparty, all of which settle on the same day, bilateral settlement netting will enable the bank to make only one or two netted payments instead of twenty-five.¹⁴ The establishment of settlement netting agreements between counterparties may be used to reduce settlement risk, operational risk, and operational costs.

Multilateral settlement netting is the practice of combining all trades between multiple counterparties and calculating a single net payment in each currency. This practice is supported by CLS Bank (CLS). CLS Best Practices can be found on the website <www.cls-services.com>.

¹⁴ Banks may also conduct “novational netting,” which nets trades across all currency pairs. For example, a dollar-yen trade and a euro-dollar trade may be netted for a single dollar payment.

Netted payments are calculated for transactions done in the same currencies with equal value dates. The bank and counterparty continue to confirm all deals on a daily basis either directly or through a system that helps support settlement netting. These systems allow a bank to view netted amounts of trades on a screen.

A summary of netted amounts by currencies and value date can also be monitored and individual netted trades can be reviewed subsequently. Trades that have been matched and confirmed are typically identified as well. Any disputes should be investigated and resolved between bank and counterparty operations units. Operations generally confirms netted amounts again on the day before settlement date in addition to confirming the transaction itself on the trade date (see the confirmation section and Best Practice no. 19).

The operational process of settlement netting should be supported by a legal agreement. Such an agreement may be a simple one-page document that only supports settlement netting, or the settlement netting provision may be included in a master agreement (see Best Practice no. 3)

Best Practice no. 25:

Use Online Settlement Netting Systems

The use of an online settlement netting system is encouraged to calculate net payments in each currency. Online software for calculation of netted payments should be used to ensure proper calculations.

Correct calculations of netted payments are important to ensure accurate settlement amounts, enhance efficiency of operations, and preserve client relationships. If, for example, a bank mistakenly expects a payment of \$2 million from a counterparty but receives \$1 million, it will initiate investigation procedures and possibly escalation procedures with the counterparty, thus possibly damaging the relationship between institutions. Faulty netting calculations also create an inaccurate assessment of a bank's credit risk with the counterparty.

Because of these risks, a bank should use online (real-time) software to calculate netted payments. By using online software, both counterparties can enter deal information into the trade capture system. The system will confirm the transactions, and will calculate, on a currency-by-currency basis, the net amount due to each counterparty. The two counter-parties to the transaction will be notified if these amounts are not equal and the resulting discrepancy may be resolved immediately.

Using online netting systems also helps to reduce settlement risk. Because online systems allow banks to quickly recognize and correct netting errors, currency exposures can be managed more effectively. If a bank conducts ten trades (within the same currency) with a counterparty, it will only experience a currency exposure for two netted amounts (one for the amount it is paying and one for the amount it is receiving) and not for twenty different amounts. When additional trades are done, the resulting exposure is added to the net exposure.

Best Practice no. 26:

Confirm Bilateral Net Amounts

Final amounts should be confirmed bilaterally with the counterparty if they are not done

electronically.

Third-party electronic settlement netting systems inform both bilateral parties of the amount that they owe and can expect to receive at some predetermined cutoff time. However, if electronic settlement netting systems are not used, then the calculations performed by one party's operations group may contain an error. To protect against an improper settlement of a net amount, counterparties should confirm the net payment amount with each other at some predetermined cutoff time.

Best Practice no. 27:

Employ Timely Cutoffs for Netting

A bank should adopt the latest cutoff time possible for confirming netted trades. Credit system functions should be in place to accurately reflect the effect of netting.

To include all transactions done between two counterparties and achieve the maximum risk reduction, the net payment amounts should be confirmed at the latest possible time. This measure will allow trades done for settlement on the trade date to be included in the net amount. As netting occurs and other trades are done with the counterparty, credit systems should be updated. Credit systems should be adapted to account for legally enforceable netting agreements and should reflect changes in credit-line usage appropriately. This allows sales and trading to appropriately deal with counterparties based on available credit and to gauge the risk associated with each deal. Deals that miss the netting cutoff should be settled gross and reflected as such for credit purposes.

Best Practice no. 28:

Establish Consistency between Operational Practices and Documentation

Management should ensure that operating practices are consistent with credit policies and other documentation. Credit systems should not reflect settlement netting benefits unless documentation exists to support settlement with counterparties on a net payment basis.

Sometimes operational practices do not follow documented policy. The trade capture system may not indicate netting counter-parties, for example, thus preventing the bank from realizing the benefits of netting. In another variance from policy, a bank might practice netting although a formal agreement has not been established with the counterparty to do so. A bank that is caught in a legal dispute, however, will not be able to justify its practices without legal and operational support. Additionally, a bank may be prevented from effectively managing its risk position.

To this end, operations management should strive to establish procedures that are in line with operational goals and follow documented procedures. Management should be certain that operational procedures ensure that netting is carried out between a bank and designated counter-parties. Operations should also ensure that netted trades are reflected in trade capture systems and credit systems so that netting is successfully executed. The operational procedures should include any necessary cut-off times, standing settlement instructions (SSIs), and an agreed method of confirmation and affirmation should be supported by each counterparty's documentation policy.

Settlement

Process Description

Settlement is the exchange of payments between counterparties on the value date of the transaction. The settlement of FX transactions can involve the use of various secure international and domestic payment system networks.

Settlement occurs and payments are exchanged on the value date of the transaction. For counterparties that are not settled on a net basis, payment instructions are sent to nostro banks for all the amounts owed—as well as for expected receipts. Settlement instructions are sent one day before settlement, or on the settlement date, depending on the currency's settlement requirements. Settlement instructions should include the counterparty's nostro agent's name and SWIFT address and account numbers if applicable. Systems generate predictions of expected movements in nostro accounts to help manage liquidity and reconcile actual cash movements against the nostro accounts.

All payments are exchanged through the aforementioned nostro accounts. These accounts are denominated in the currency of the country where they are located. When a bank enters into a contract to buy dollars and sell yen, for example, it will credit its yen nostro account and debit its dollar nostro account. The counterparty credits its dollar nostro account and debits its yen nostro account in Japan. Both banks initiate a money transfer to pay their respective counterparties; this is done by a funds movement between the two banks using the local payment system. The money transfer is complete when both counterparties have been paid the appropriate amounts.

If settlement error occurs in the process, it is typically quite costly. If a bank fails to make a payment, it must compensate its counterparty, thus generating additional expense. Settlement errors may also cause a bank's cash position to be different than expected.

In addition, settlement risk—the risk that a bank makes its payment but does not receive the payment it expects—can cause a large loss. This risk arises in FX trading because payment and receipt of payment often do not occur simultaneously. A properly managed settlement function reduces this risk. Settlement risk is measured as the full amount of the currency purchased and is considered at risk from the time a payment instruction for the currency sold becomes irrevocable until the time the final receipt of the currency purchased is confirmed.¹⁵

Sources of this risk include internal procedures, intramarket payment patterns, finality rules of local payments systems, and operating hours of the local payments systems when a counterparty defaults. Settlement risk may have significant ramifications and is controlled through the

¹⁵ For additional information on settlement risk, please see the following: Foreign Exchange Committee, "Defining and Measuring FX Settlement Exposure," in *The Foreign Exchange Committee 1995 Annual Report* (New York: Federal Reserve Bank of New York, 1996). Foreign Exchange Committee, "Reducing FX Settlement Risk," In *The Foreign Exchange Committee 1994 Annual Report* (New York: Federal Reserve Bank of New York, 1995).

continuous monitoring of the bank's nostro balances and through the establishment of counterparty limits.

A maximum settlement risk limit is usually established for each counterparty. Notably, the introduction of the CLS Bank has increased the efficiency of settlement by introducing a mechanism for simultaneous exchange of currencies on an intraday and multilateral basis.

Best Practice no. 29:

Use Real-Time Nostro Balance Projections

Nostro balance projections should be made on a real-time basis and should incorporate the latest trades, cancellations, and amendments.

A bank is exposed to risk when managing its nostro funds if expected cash positions vary greatly from actual cash positions. If more cash is needed than the balance in an account, the bank will incur overdraft costs to fund the positions. Continual overdraft balances will generate expenses for the bank and may cause operational difficulties when the bank makes efforts to determine why errors occurred.

Best Practice no. 30:

Use Electronic Messages for Expected Receipts

A bank should send its nostro banks an electronic message that communicates its expected receipts.

With the receipt of an electronic message advising of expected receipts, nostro banks can identify payments that are directed to an incorrect account early in the process. This allows nostro banks to correct payment errors on a timely basis and aids in the formulation of escalation procedures. This process can help a bank to receive the exact funds they expect and to eliminate unmatched or unreceived payments. Some nostro banks will take the transaction reference number from an incoming electronic message and put the number on its outgoing nostro activity statement.

Some nostro banks, however, are not equipped to process these expected receipt messages. Given the benefits that accrue through the use of expected receipt messages, a bank should consider a nostro's ability to process these messages when choosing which nostro bank to use.

Best Practice no. 31:

Use Automated Cancellation and Amendment Facilities

A bank should establish a real-time communication mechanism with its nostro bank to process the cancellation and amendment of payment instructions.

A bank may need to change or cancel payment instructions after they have been released to nostro banks. Problems may arise if this information is not processed in a timely manner. Amendments occur when an error in the original instruction has been identified or a counterparty has made a last minute change. Because execution of the erroneous payment instruction will certainly create an improper settlement, the bank needs to be sure the amendment is acted upon so that its nostro balance predictions are accurate. More importantly, a

bank may wish to cancel a payment instruction if it is reasonably confident that a counterparty may not fulfill its obligation to pay the counter-currency.

An automated feed from the operations system to the nostro bank will make communication of amendments and cancellations easier. Nostro banks will be able to establish later deadlines for payment amendments because a real-time link provides more time to process the changes. Such a link also decreases the chance that a bank will miss the payment deadline and should prevent incorrect payments from being released.

Best Practice no. 32:

Implement Timely Payment Cutoffs

Management should work to achieve the latest possible cut-off times for cancellation and alteration of payment instructions to nostro banks as well as the earliest possible times for confirmation of final receipts.

By eliminating restrictive payment cancellation deadlines and shortening the time it takes to identify the final and failed receipt of currencies, a bank can lower its actual and potential settlement exposure. A bank should understand when it can unilaterally cancel or amend a payment instruction and negotiate with its nostro banks to make this cutoff as late as possible. In addition, such policies give a bank more control over its payments, allowing it to react to any problems that arise late in the settlement process.

Best Practice no. 33:

Report Payment Failures to Credit Officers

Operations should ensure that credit reports appropriately update settlement exposure resulting from projected cash flow movements. Exposure amounts should include any failed receipts from previous transactions.

To properly manage its credit risks, a bank needs to monitor settlement exposure to each of its counterparties. Settlement exposure exists for a FX transaction from the time that the payment instruction issued by the bank is no longer unilaterally revocable by the nostro bank to the time that the bank knows it has received the counter-currency from the counterparty. Therefore, credit officers need to know the projected settlement amounts for each counterparty. In addition, any nonreceipts should be included in current exposure amounts reported to the credit officers. Nonreceipts indicate an increased exposure to the counterparty until the amount has been paid, and may also suggest a more serious problem with the counterparty.

Best Practice no. 34:

Understand the Settlement Process and Settlement Exposure and Use Settlement Services Wherever Possible to Reduce Settlement Risk within the Market

Market participants should measure and monitor settlement risk exposures. All senior managers should obtain a high-level understanding of the settlement process as well as of the tools that exist to better manage settlement risk. Additionally, both credit and risk managers (those managing position risk and credit risk) should be cognizant of the impact their internal procedures have on settlement exposure.

Settlement risk may be reduced if those involved in the process better understand the ramifications of its possible failure. Senior management, sales and trading, operations, risk management, and credit management should understand the process and be aware of the timing of the following key events in the process: when payment instructions are recorded, when they become irrevocable, and when confirmation of counterparty payment is received with finality. Knowledge of these items allows the duration and amount of FX settlement exposure to be better quantified.

Both credit and risk managers should develop accurate methods to quantify settlement risk. A bank's actual exposure when settling an FX trade equals the full amount of the currency purchased, and lasts from the time a payment instruction for the currency sold can no longer be canceled unilaterally until the currency purchased is received with finality.¹⁶

Market participants should adequately utilize settlement services that reduce their exposures to settlement risk whenever possible, for example, through the use of payment-versus-payment services, such as those offered by CLS, for the settlement of eligible foreign exchange transactions. Counterparties currently unable to use such services should be encouraged to consider ways to use them.

Best Practice no. 35:

Prepare for Crisis Situations outside Your Organization

*Operations employees should understand the procedures for crisis situations affecting settlement. They should know who to notify if payments must be canceled or if settlement procedures must be changed.*¹⁷

Crisis situations such as a failure of a bank's settlement processing systems, potential bankruptcy, or political unrest present critical decisions for a bank, especially with regard to credit and liquidity management. Firms should anticipate crises and prepare internally. A bank's failure to settle properly with counterparties could prove harmful if a counterparty defaults on the expected payments. Consequently, operations should know precisely what to do in a crisis. Current nostro bank staff contact lists should be distributed. These lists should contain emergency contact numbers and contact information for each nostro bank's contingency operation.

Operations should also understand alternative settlement procedures and how they are executed. Finally, operations staff should know who to inform and how to inform them of changes or cancellations in payment instructions. A bank may wish to consider simulated exercises of crisis situations to ensure that employees are familiar with alternative procedures and can manage them effectively.

¹⁶ Foreign Exchange Committee, "Defining and Measuring FX Settlement Exposure," in *The Foreign Exchange Committee 1995 Annual Report* (New York: Federal Reserve Bank of New York, 1996).

¹⁷ Foreign Exchange Committee, "Reducing FX Settlement Risk," In *The Foreign Exchange Committee 1994 Annual Report* (New York: Federal Reserve Bank of New York, 1995).

Nostro Reconciliation

Process Description

Nostro reconciliation occurs at the end of the trade settlement process to ensure that a trade has settled properly and that all expected cash flows have occurred. A bank should begin reconciliation as soon as it receives notification from its nostro bank that payments are received. If possible, reconciliation should be performed before the payment system associated with each currency closes. Early reconciliation enables a bank to detect any problems in cash settlement and resolve them on the settlement date. Typically, however, a bank does not receive notification from its nostro banks until one day after settlement, which does not allow them to correct payment errors on the settlement date.

Reconciliation begins with the prediction of cash movements. The bank's operations unit identifies those trades that are valued for settlement the next business day. Operations aggregates all payments for that value date, taking into account netted payments and determining what the expected cash movement will be for each of its nostro accounts. This process allows the bank to accurately fund those nostro accounts.

The main objective of the nostro reconciliation function is to ensure that expected cash movements agree with the actual cash movements of currency at the nostro bank. This involves comparing expected cash movements with actual cash movements both paid out and received in by the nostro bank. If the reconciliation indicates a difference from expected amounts, there are six possible reasons. A bank may have

- expected to receive funds and did not,
- expected to receive funds and received the wrong amount,
- received funds and did not expect to receive them,
- expected to pay funds and did not,
- expected to pay funds and paid the wrong amount, or
- paid funds and did not expect them to be paid.

If any differences are found, the bank must follow up with the nostro bank and/or the counterparty to resolve the discrepancy. The cause for the difference might be that wrong settlement or trade information was captured or that the nostro bank made an error. Most of such errors can be avoided if the confirmation process is followed without exception. If the discrepancy was caused by an error at the bank, then the bank must arrange to pay the counterparty with good value or to pay the counterparty compensation. Similarly, if the error occurred at the counterparty or at the nostro bank, then the bank should expect to receive good value or compensation.

If the nostro reconciliation is not performed, or is performed incorrectly, then the balances at the nostro bank will be different from those the traders believe they are funding. Consequently, the bank will be paying overdraft costs on any short balances or receiving less than market rates on any long balances. In some currencies, the central banks have penalties for carrying short balances in addition to the overdraft charges due. Failure to notify counterparts of problems in a timely manner may lead them to dismiss claims that are over a certain age, causing the bank to

absorb the overdraft costs. In addition, nostro reconciliation serves as a main line of defense in detecting fraudulent activity.

Banks should implement procedures to periodically review the terms and conditions of each nostro agent and evaluate usage of each nostro account.

Best Practice no. 36:

Perform Timely Nostro Account Reconciliation

Full reconciliation of nostro accounts should be completed as early as possible.

A bank should attempt to establish capabilities that allow for intraday processing of nostro confirmations of receipts, thereby allowing the reconciliation process to begin before the end of the day. In no instance, however, should the reconciliation be done later than the day following settlement date. The sooner reconciliations are performed, the sooner a bank knows its true nostro balances so that it can take appropriate actions to ensure that its accounts are properly funded. In addition, nonreceipt of funds may indicate credit problems at a counterparty. The sooner this information is known, the sooner a bank can prevent further payments from being made to that counterparty.

Best Practice no. 37:

Automate Nostro Reconciliations

A bank should be capable of receiving automated feeds of nostro activity statements and implement automated nostro reconciliation systems.

A bank should establish facilities for automatically downloading the settlement information it receives from nostro banks as well as its own expected settlement data. A bank should establish an electronic reconciliation system to compare these two streams of data (confirmed payments and receipts from the nostro bank against the expected cash movements from the operations system) to allow for the timely identification of differences. Escalation procedures should be in place to deal with any unreconciled trades and/or unsettled trades. These procedures should be initiated when settlement and/or nostro reconciliations are not successful.

Best Practice no. 38:

Identify Nonreceipt of Payments

Management should establish procedures for detecting non-receipt of payments and for notifying appropriate parties of these occurrences. Escalation procedures should be in place for dealing with counterparties who fail to make payments.

A bank should attempt to identify, as early in the process as possible, any expected payments that are not received. They should be prioritized by counterparty credit ratings, payment amount and currency, or by an internally generated counterparty watch list. All failed receipts should be subject to established follow-up procedures. A bank should also report nonreceipts to credit management and to sales and trading, particularly for any recurring failures with one particular counterparty. Management may wish to consider a limited dealing relationship with counterparties who have a history of settlement problems and continue to fail on their payments

to the bank. Payment of interest and penalties should be prompt.

Best Practice no. 39:

Establish Operational Standards for Nostro Account Users

A bank should require all other users of its nostro accounts to comply with the same operational standards as FX users.

The FX department of a bank may be the primary user of nostro accounts. However, other business groups (for example, fixed income, commodities, emerging markets, and derivatives) may also be users. Clear procedures should be established outlining how each account is funded (that is, individual or group funding). Consistent standards should be in place describing the necessary operating procedures that all users should follow. Without clear rules for sharing in place, the bank runs the risk of overdraft problems.

Accounting/Financial Control

Process Description

The accounting function ensures that FX transactions are properly recorded to the balance sheet and income statement. If transaction information is not recorded correctly, a bank's reputation may be impaired if material restatements of financial accounts are necessary.

Accounting entries are first booked following the initiation of a trade. At this point, details of the deal are posted to contingent accounts (typically in a system used by operations). At the end of each trade day, all sub-ledger accounts flow through to the general ledger. There are two common methods for transferring and validating P&L information in the general ledger.

In some banks, the sales and trading system compiles all of this data and develops a P&L figure for each day. The operations staff later verifies the P&L figure. Other banks calculate two P&L figures independently: one is calculated by sales and trading, and one by the operations system. An independent party, such as the risk management division, verifies both P&L figures. Each morning, the P&L of the prior day's business is verified by the financial management function and analyzed by senior management.

The accounting area should ensure that following the initial entry of a trade into the general ledger, the position is continually marked to market until it is closed out. Daily marking to market calculates unrealized gains and losses on the positions that are fed into the general ledger and the daily P&L. Once these positions are closed out, realized gains and losses are calculated and reported.

All subsidiary ledger accounts (including all brokerage accounts and suspense accounts) are reconciled to the general ledger daily. Additionally, on a monthly basis (usually at month-end) an independent check is done to ensure that all subsystem accounts reconcile to the general ledger accounts. All discrepancies are investigated as soon as possible to ensure that the bank's books and records reflect accurate information. In addition, all discrepancies that have an

impact on how the bank reports gains or losses are reported to senior management.

Cash flow movements that take place on settlement date are also posted to the general ledger in accordance with accepted accounting procedures. The receipt and payment of expected cash flows at settlement are calculated in a bank's operations system. There are times when cash flows must be changed because of trade capture errors, which require changes to a sub-ledger account. Accounting entries are modified so that the general ledger accurately reflects business activities; the change flows to the operations system where appropriate cash flow adjustments are made.

Best Practice no. 40:

Conduct Daily General Ledger Reconciliation

Systematic reconciliations of 1) the general ledger to the operations system, and of 2) sales and trading systems to the operations systems should be done daily.

Timely reconciliations will allow for prompt detection of errors in the general ledger and/or sub-ledgers and should minimize accounting and reporting problems. This reconciliation will ensure that the general ledger presents an accurate picture of an institution's market position. When problems are detected, they should be resolved as soon as possible. Senior management should be notified of accounting discrepancies to review and update control procedures as needed.

Best Practice no. 41:

Conduct Daily Position and P&L Reconciliation

Daily P&L and position reconciliations should take place between the sales and trading and operations systems.

Position reconciliations allow a bank to ensure that all managed positions are the same as those settled by operations. This control is imperative when all deal entries and adjustments are not passed electronically between sales and trading and operations. When straight-through processing is in place, the reconciliation ensures that all deals were successfully processed from sales and trading to operations, along with all amendments. Because a discrepancy in P&L between sales and trading and operations can indicate a difference in positions or market parameters (that is, rates or prices) all differences should be reported, investigated, and resolved in a timely manner.

Banks that maintain a single system for trade capture data should ensure that the data source is properly controlled.

Best Practice no. 42:

Conduct Daily Position Valuation

Position valuations should be verified daily by a staff that is separate from sales and trading. Preferably, position valuation should be conducted by an independent third party such as the risk management staff. Position valuation should be checked against independent price sources (such as brokers or other banks). This is particularly important for banks that are active in less liquid forward markets or in exotic options markets. Trading management should be informed

of the procedures used for marking to market to ensure that they can appropriately manage trade positions.

P&L is an integral part of the daily control process; thus, it is important for the calculation to be correct. The appropriate end of day rates and prices that are used to create the position valuations should be periodically checked by an independent source. Either operations or risk management should check that the rates and prices used by sales and trading for end-of-day valuation are close to the market rates.

Position valuations should be verified using independent sources such as market rate screens, other dealers, and/or broker quotations. In addition, at least once a month, the results of the models should be checked against other dealers and/or brokers to ensure that the valuations produced by the bank's models are consistent with other dealers.

Illiquid markets present additional risk to a bank because illiquid instruments are infrequently traded, making them difficult to price. Often, it is hard for a bank to obtain market quotes, thereby preventing timely and consistent position monitoring. P&L may be distorted and risk may not be properly managed. In such instances, a bank should seek to obtain quotes from other counterparties active in the market. Management should be aware of these procedures so that they may effectively manage and evaluate illiquid market positions. These procedures allow a bank to mark to market its positions and to evaluate associated risks. All market participants should be aware that an FX option portfolio is not effectively marked to market unless the valuation reflects the shape of the volatility curve. With consideration given to the size of portfolio and daily activity, positions should wherever possible be revalued reflecting the "smile effect" when the firm wishes to mark to market. Where appropriate, firms should reserve against liquidity and pricing risk.

Marking to market reflects the current value of FX cash flows to be managed and provides information about market risk.¹⁸ Senior management will be able to better manage and evaluate market positions when they know how positions are valued on a daily basis.

Best Practice no. 43:

Review Trade Prices for Off-Market Rates

Trade prices for both internal and external trades should be independently reviewed to ensure reasonableness within the market prices that existed on the trade date.

Any trades executed at prices not consistent with the market rates that existed at the time of execution may result in an error for the bank or may unduly enrich the bank or the counterparty. Banks should institute a daily procedure that provides for independent manual or automated review of trade prices versus prevailing market rates.

Best Practice no. 44:

Use Straight-Through Processing of Rates and Prices

¹⁸ Group of Thirty, Global Derivatives Study Group, *Derivatives: Practices and Principles* (Group of Thirty, 1993), p.19.

Rates and prices should be fed electronically from source systems.

The valuation of positions requires many different rates and prices, sometimes collected from different sources. To eliminate the errors associated with collecting and re-keying the required rates and prices, a bank should establish electronic links from the systems that source the rates and price information to the position valuation systems.

Unique Features of Foreign Exchange Options and Non-Deliverable Forwards

Process Description

Foreign exchange (FX) options and non-deliverable forwards (NDFs) have unique features that need to be handled differently than spot and forward FX transactions. Specifically in the areas of

- option exercise and expiry,
- rate fixings for NDFs and some nonvanilla options, and
- premium settlements for options.

Options exercise/expiry requires the determination of the intrinsic value of the instrument. The intrinsic value is the amount by which the option is in-the-money. To determine this value, the strike price of an option must be better than the market rate at the time of expiration. This special event is one of the unique features of options. Options have inherent risk associated with failure to perform events such as exercising in-the-money transactions or obtaining fixings for non-vanilla options (such as average rate or average strike). Senior operations management should clearly define roles and responsibilities to ensure that these inherent risks are reduced.

NDFs, much like options, also require additional processing. NDFs are cash-settled FX instruments that require a rate fixing to determine the cash settlement amount. Daily review of outstanding transactions must be performed to ensure that fixings are obtained as required in the confirmation language. Fixings are communicated by notification of a fixing advice. Responsibility for the notification of the fixing advice should be part of the confirmation process and performed by operations personnel.

The confirmation process for both FX options and NDFs is comparable to straight FX trades. The difference is that FX options and NDFs require additional language and staff must understand more than the usual terms and conditions in order to reduce operational risk. In all other respects, FX options and NDFs should be treated the same way as spot and forward FX trades as outlined in this document.

Best Practice no. 45:

Establish Clear Policies and Procedures for the Exercise of Options

Banks should have clear policies and procedures that define roles and responsibilities and describe internal controls on the process of exercising and expiring foreign currency options.

Banks should mitigate operational risk by implementing policies and procedures in conjunction

with oversight departments and by assigning clearly defined roles and responsibilities. Determination of an in-the-money option and notification to the counterparty should be performed via an independent, audible electronic system. Exercising options, for example, should be segregated from sales and trading and performed by staff that communicates between the front- and back-office personnel.

Additionally, to reduce the likelihood that transactions are not exercised, systems should be designed to auto-exercise in-the-money transactions. Oversight is necessary in the form of measuring options against market rates, thereby ensuring that in-the-money transactions are exercised appropriately. Foreign exchange trades resulting from exercised options should automatically and electronically flow to the back-office FX processing system if a separate application is used from the option processing system.

Best Practice no. 46:

Obtain Appropriate Fixings for Nonstandard Transactions

Ensure that nonstandard transactions (such as non-deliverable forwards [NDFs], barrier, average rate, and average strike options) with indexing components are fixed with the appropriate rates as provided in the language of the confirmation or master agreement documentation.

Operations staff, independent of sales and trading, should obtain the fixing rates as defined in the confirmations for all nonstandard transaction types (such as NDFs, average rate, average strike option trades). Confirmations should be reviewed on the trade date to determine the fixing source. This fixing information should be captured by the back-office operational transaction processing system and noted on the individual confirmations. On the fixing date, fixing advices should be generated and forwarded electronically (where possible) to the counterparty reflecting the fixing rate and settlement amount.

Best Practice no. 47:

Closely Monitor Option Settlements

Option premium settlements should be closely monitored to reduce the potential for out-trades. Premium settlement of options should be monitored closely to reduce the potential for out-trades.

Option premium amounts can be small and not reflect the notional amount of the option transaction. Ensuring that the counterparty receives the settlement of the premium can be an indication that the counterparty is aware of the position, albeit not the details of the trade, which would be covered in the confirmation.

General Best Practices

Process Description

This section suggests general best practices that apply to all segments of the FX process flow.

Best Practice no. 48:

Ensure Segregation of Duties

The reporting line for operations personnel should be independent of the reporting line for other business lines (sales and trading, credit, accounting, audit, and so on). For key areas, operations management should ensure that an appropriate segregation of duties exists within operations and between operations and other business lines.

Operations cannot be completely effective in performing its control functions if its members report to an area that they are assisting. Operations must be able to report any and all issues to an independent management team. To do so, operations must have a reporting line that is not directly subject to an organizational hierarchy that could lead to a compromise of control. In addition, the compensation process for operations personnel should be clearly segregated from that of the compensation process of sales and trading.

Examples of good practices include:

- precluding individuals from having both trading and confirmation/settlement responsibilities concurrently,
- precluding sales and trading personnel from issuing and authorizing payments,
- precluding individuals from having both posting and reconciling access to the general ledger,
- not allowing established procedures to be overridden without operations management's consent, and
- separate database functions between sales and trading and operations.

Best Practice no. 49:

Ensure That Staff Understand Business and Operational Roles

Operations and sales and trading personnel should fully understand all FX business strategies and the role of each participant within the FX process flow (for example, clients, credit, compliance, and audit). Policies and procedures should be documented and updated periodically.

Business strategies, roles, responsibilities, and policies and procedures continually change and evolve. Each group or individual playing a role in the FX process flow should have a complete understanding of how FX trades are initiated, processed, confirmed, settled, controlled, and accounted. Insufficient knowledge of the overall FX process, or the role played by each individual or group, can lead to an improper segregation of duties, insufficient controls, and/or increased risk. All market participants should provide continuous employee education regarding business strategies, roles, responsibilities, and policies and procedures. The development of effective “front-to-back” training should be encouraged to ensure that all elements of the FX business are clearly understood by all. All market participants should insure that policies and procedure documents are current, documented, maintained, and available to all.

Best Practice no. 50:

Understand Operational Risks

Market participants should fully understand operational risks.¹⁹ To help mitigate operational risks, every market participant should implement adequate controls, modify processes and flows when appropriate, and/or invest in improved technology. Current as well as potential operational risks associated with new industry process changes (for example, the CLS Bank, web portals, and so on), should be assessed on a regular basis, quantified wherever possible, and reported to senior management.

Areas of exposure within the FX processing cycle need to be identified, quantified where possible, and adequately controlled. With better information regarding operational risks, institutions can make informed decisions about which risks they are going to assume and which risks need to be managed either through enhanced process flows and controls or through investments in improved technology. Proactive thinking concerning current and future trends is recommended.

Best Practice no. 51:

Identify Procedures for Introducing New Products, New Customer Types, or New Trading Strategies

All market participants should have adequate procedures and controls in place for introducing new products, new customer types, or new trading strategies. These procedures and controls should include a provision to ensure that the participant has the capability to initiate, price, value, confirm, and settle these new types of transactions, customers, or strategies. The market participant should also be able to measure, monitor, and report all risks associated with new products, customers, or strategies.

When a new product, new customer, or new business strategy is introduced, all areas—operations, sales and trading, financial control, risk control, legal, compliance, technology, and others—should be fully knowledgeable and prepared to execute and process the new dealings in a controlled environment. New products, new customer types, or new business strategies may introduce different types of risks or increase existing risks. They may also result in different methods of trade capture, confirmation, netting, settling, reconciling, and/or P&L reporting. Any change to existing processes, practices, or policies should be effectively controlled and reported. Procedures and controls that detail operational and systems support guidelines should be documented and published.

Best Practice no. 52:

Ensure Proper Model Sign-off and Implementation

Quantitative models often support FX trading activities. As a result, their implementation and management should be a coordinated effort among the various FX business lines. Model implementation and maintenance should ensure that all FX business lines (Sales & Trading, Operations, financial control, risk control, technology, audit, and others) approve, support, and understand the model purpose and capabilities, as well as the roles and responsibilities of each business line. Further, to maintain appropriate segregation of duties, model validation, model technical development, and data input and output reporting should all be performed independently from Sales & Trading.

¹⁹ See the “What Is Operational Risk?” in this document, p. 3.

Models may be used to report positions, to manage position risk, or to price financial instruments. New models, or modifications to existing models, may change or challenge established policies, procedures, and/or practices. It is important that all FX business lines understand how the pricing of certain instruments will change and how position monitoring will be evaluated if a new model is introduced or an existing model modified. Model risk and potential business disruptions can be effectively controlled through cross business line approval, implementation, management, and education.

Best Practice no. 53:

Control System Access

Users of a system (for example, operations, sales and trading) should not be able to alter the functionality of production systems. Developers should have limited access to production systems, and only in a strictly controlled environment. Each system should have access controls that allow only authorized individuals to alter the system and/or gain user access. Function-specific user access “profiles” are suggested.

As alternative technologies (for example, web-based trading) continue to emerge in the FX trading and processing environments, rigorous controls need to be implemented and monitored to ensure that data integrity and security are not sacrificed. External user access controls should be as robust as internal user access controls.

Access to production systems should only be allowed for those individuals who require access in order to perform their job function. When creating user access profiles, system administrators should tailor the profile to match the user’s specific job requirements, which may include “view only” access. System access and entitlements should be periodically reviewed, and users who no longer require access to a system should have their access revoked. Under no circumstance should operations or sales and trading have the ability to modify a production system for which they are not authorized.

Best Practice no. 54:

Establish Strong Independent Audit/Risk Control Groups

Market participants should have sophisticated and independent audit/risk control groups. It is recommended that market participants perform rigorous self-assessments and publish regular reporting of such to management, the business line, and audit/risk control groups. Firms should implement policies and procedures that enable employees to raise concerns anonymously.

The audit/risk control groups play a most important role. They ensure that quantifiable and effective controls are in place and working properly and that policies and procedures are relevant as well as followed. The goal of these groups is to protect the market participant against financial or reputation loss by monitoring or uncovering flaws in the process or procedures and suggesting corrective action. These groups must not have a reporting line that is subject to an organizational hierarchy that could lead to a compromise of control, assessment, or escalation.

Best Practice no. 55:

Use Internal and External Operational Performance Measures

Operational performance reports should be established to clearly measure and report on the quality of both internal and external (outsourced) operational performance. The report measurements should focus on operational efficiency and controls, and be reviewed on a regular basis by both operations and sales and trading management.

Operational performance reporting should contain quantifiable performance metrics at the levels of detail and summary, and indicate the status of operational activities. Typical key performance measures would include confirmation, acceptance and aging reporting, nostro and cash balance reporting, operational error and loss reporting, and any other relevant data deemed necessary by the participant. These reports should serve to control and proactively monitor risk and performance.

Market participants may employ Service Level Agreements (SLAs) as a way of improving and controlling operational performance. SLAs should always be exchanged when outsourcing all or part of a participant's operation. SLAs should clearly define, measure, and report on operational performance. External (outsourced) performance measurements should be as robust as internal performance measurements.

Best Practice no. 56:

Ensure That Service Outsourcing Conforms to Industry Standards and Best Practices

If a bank chooses to outsource all or a portion of its operational functions, it should ensure that its internal controls and industry standards are met. A bank that outsources should have adequate operational controls in place to monitor that the outsourcer is performing its functions according to agreed-upon standards and industry best practices.

A bank may choose to outsource some or all of its operations functions. However, outsourcing should in no way compromise a bank's internal standards for confirmations, settlement and payments. Controls should be in place to monitor vendors to ensure that internal standards are met. For example, trades should still be confirmed in a timely manner and proper escalation and notification procedures must be followed.

Best Practice no. 57:

Implement Globally Consistent Processing Standards

When a bank has multiple processing centers, it should ensure that bankwide standards are met in each location. Banks should use consistent procedures and methodologies throughout the institution. Satellite offices or separate entities require close oversight to ensure that they conform to the standards of the bank.

Some banks may maintain multiple processing centers in different locations around the world. Regional processing may allow a firm to maintain around-the-clock processing for multiple front-end trading locations. However, it is essential that a firm's standards and processes are consistent throughout the bank. Although different processing centers may rely on different systems or technology, the standards and procedures should be the same in every processing center. For example, valuation methodologies should remain consistent throughout the firm.

In addition, some firms may rely on centralized booking and operations, but may have specific exceptions, such as satellite offices, or branches that serve as separate legal entities. Such sites should be carefully monitored to ensure that their bank's standards are being met.

Best Practice no. 58:

Maintain Records of Deal Execution and Confirmations

Banks should maintain documentation supporting the execution of foreign exchange trades. Such documentation should provide a sufficient audit trail of the events throughout the deal execution, trade, and validation process. This documentation may be in the form of written or electronic communication, a tape recording, or other forms evidencing the agreement between the parties. Documentation should cover communication not only between the sales and trading groups of the bank and the counterparty but also between the operations area of the bank and the counterparty.

Deal execution and confirmation documentation can aid institutions in verifying trade details and ensure that amounts were confirmed as expected. This step may help a bank if it becomes involved in counterparty disputes. For each trade, the following information should be documented: currencies, amount, price, trade date, value date and the notional currency of each transaction.

The length of time that a bank keeps records (which may be left to management's discretion) depends on the type of business they transact and may also be subject to local regulations. Record retention, for example, may depend on the character of a bank's forward trading or long-dated options trading.

It is important to note that trades conducted over the telephone pose particular risks. The phone conversation is the only bilateral record of the trade details, at least until the trade is validated through the traditional confirmation process. Until this confirmation process is completed, market participants should establish close controls to minimize the exposure inherent in such trades.

Best Practice no. 59:

Maintain Procedures for Retaining Transaction Records

The operations group is responsible for retaining adequate records of all transactions and supporting documentation for the financial statements.

Operations must maintain detailed records of all transactions executed and of all information to support its P&L and position calculations. Each market participant should determine appropriate record retention based on tax, regulatory, and legal requirements for each jurisdiction. It is recommended that records be maintained in duplicate and in a location separate from where primary processing occurs.

If and when external vendors or storage facilities are employed, it is essential that they provide a similar backup facility. Records can be maintained on paper, optical, or magnetic media. If a computer-based format is used, the programs and their documentation need to be retained so that the data can be read at a later date. Special care must be taken because newer versions of

software frequently cannot read older data files. Older programs may also not run correctly on newer operating systems or machines. In addition, magnetic media must be maintained carefully because it degrades in adverse conditions.

Best Practice no. 60:

Develop and Test Contingency Plans

*Operations and sales and trading should develop plans for operating in the event of an emergency. Contingency plans should be periodically reviewed, updated, and tested. These contingency plans should cover both long-term and short-term incapacitation of a trading or operations site, the failure of a system, the failure of a communication link between systems, or the failure of an internal/external dependency. These plans should include informing, monitoring, and coordinating personnel.*²⁰

The primary risk of a major disaster is that a market participant may not be able to meet its obligation to monitor its market positions. Many market participants deal in high volumes of large trades. Failure to be able to trade or settle transactions from a given center (or several trading centers in the case of centralized operations processing) could subject the market participant to severe financial and reputational repercussions.

Market participants should identify various types of potential disasters and identify how each may prohibit the participant from satisfying its obligations (that is, issuing and receiving confirmations, performing settlements, and completing daily trading). Disaster recovery plans should identify requisite systems and procedural backups, management objectives, people plans, and the methodology or plan for dealing with each type of disaster. Disaster recovery plans should be reviewed on a regular basis, and tested periodically, to gauge the effectiveness of the plans themselves and measure staff readiness.

An emergency crisis team, equipped with key personnel contact lists, should be established to monitor crisis and coordinate recovery efforts. Market participants should develop contingency contact lists (for both internal and external dependencies) and distribute them to employees. All personnel should know whom to contact in the event of a disaster. Market participants should also maintain emergency contact information to reach primary counterparties. Counterparty information records should include contingency site phone numbers and emergency contact information for key personnel.

Backup sites that can accommodate the essential staff and systems of operations and sales and trading should be set up, maintained, and tested on a regular basis. Particularly for operations, market participants should consider developing a backup site that relies on a separate

²⁰ Additional guidance on foreign exchange contingency planning is provided by Foreign Exchange Committee, "Contingency Planning: Issues and Recommendations," In *The Foreign Exchange Committee 2001 Annual Report* (New York: Federal Reserve Bank of New York, 2002). Several regulatory bodies offer guidance on firm wide contingency planning. The Federal Reserve Bank of New York offers guidance at <<http://www.newyorkfed.org/bankinfo/circular/10952.pdf>>. Broker/dealers may look to several documents from the Securities and Exchange Commission and the Securities Industry Association for guidance, including <http://www.sec.gov/divisions/marketreg/lessons_learned.htm> and <http://www.sia.com/business_continuity/pdf/bestpractices.pdf>

infrastructure (electricity, telecommunications, etc.) and an alternative workforce. Banks may want to leverage multiple processing sites to serve as emergency backup facilities in the event of an emergency. In case of primary system failure, backup systems should be available and capable of acting as primary systems. These systems should provide for payment and settlement as well as the monitoring and managing of both position and settlement risk. Backup systems should have access to current and historical data which should be backed-up in a separate location from the primary site.

Market participants' business continuity plans should take into consideration the technical support requirements of their critical processing systems. Backup sites should be able to access critical confirmation and netting systems, key liquidity providers, and other industry utilities. Business continuity plans should also consider the recovery capabilities of critical service providers, in particular, their clearing and third party settlement banks.

Additionally, all market participants should identify and practice alternative methods of confirmation and settlement communication with nostro banks. These methods may require the use of fax or telex to ensure proper processing.

During a disaster, a bank should notify its counterparties of potential processing changes. A bank should also provide counterparties with current contact information for key personnel to ensure that counterparties can contact the bank in an emergency.

Market participants should ensure that the communication tools used by operations and sales and trading are secure. If phone systems fail, backup systems should exist (that is, cellular or non-PBX phones). All market participants should be connected to multiple phone substations to further prepare for disaster.

During market disturbances, market participants should pay special attention to guidance communicated by industry groups such as the Foreign Exchange Committee and the Singapore Foreign Exchange Market Committee. Industry groups may provide special recommendations in times of market stress to aid the flow of information on special issues that may arise.

Conclusion

This paper has reviewed the entire foreign exchange process flow and best practices for maintaining a properly controlled environment. However, as noted in the introduction, several trends in the industry will affect a bank's ability to implement the best practices as listed in this document. Although the market will continue to evolve and develop mitigating controls, and any set of recommendations will eventually require revision, management should consider the practices suggested here as helpful responses to recent developments in technology, instruments, and innovations in the marketplace.

The first step toward a properly controlled environment is an appropriate segregation of duties between sales and trading, and operations. However, such segregation of duties does not imply that operations should be viewed as separate from other business lines. On the contrary, the authors of this paper feel that the closer operations management is to the pulse of business, and

the better the communication between sales and trading management and operations management, the more responsive operations can be to changes in the business environment. Ultimately, better links between an institution's divisions will enable business as a whole to be better controlled.

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